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No. 871

In the Supreme Court of the United States

OCTOBER TERM, 1967

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ~~COLORADO~~ Wyoming, PETITIONER,

v.

RALPH E. BARBY AND MARIE BARBY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

ERWIN N. GRISWOLD,
Solicitor General,
MITCHELL ROGOVIN,
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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. ——

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ~~COLUMBIA~~ OKLAHOMA, PETITIONER

v.

RALPH E. BARBY AND MARIE BARBY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of Earl R. Wiseman, Director of Internal Revenue for the District of Oklahoma, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, which became final on July 5, 1967.

OPINIONS BELOW

The opinion of the district court (R. 106–114)[1] is not officially reported. The opinion of the court of appeals (App. 11–15 *infra*) is reported at 380 F. 2d 121.

JURISDICTION

The judgment of the court of appeals was entered on July 5, 1967. By order dated September 29, 1967,

[1] "R." references are to the pages of the original appellate record; "App." references are to the appendix to this petition.

Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including December 2, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

As grantors of an oil and gas lease, respondents reserved a one-eighth royalty and a $300,000 oil payment which was expected to pay out, as it did, in a few years. Then, while retaining the royalty, they assigned the production payment, in equal halves to third parties for $150,000 for each half. The question presented is whether the $300,000 received for the assignment of the production payment was capital gain, as the court below held, or ordinary income subject to the depletion allowance, as petitioner contends.

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 1221. Capital Asset Defined.

For the purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade of business, of a character which is subject to the

allowance for depreciation provided in section 167, or real property used in his trade or business;

* * * * * *

(26 U.S.C. 1964 ed., Sec. 1221.)

STATEMENT

Respondents owned land having deposits of oil and gas. On November 5, 1956, they leased this land to Cabot Carbon Company, reserving a one-eighth royalty and an oil payment of $300,000 payable out of production from 90 percent of the lessee's working interest.[2] On the same day, they conveyed a one-half interest in the $300,000 production payment to Eby, Inc., for $150,000, and on January 3, 1957, they conveyed the other one-half to Today Oil Company for $150,000. (R. 22–23.) Taxpayers retained their royalty interest, to run for the life of the mineral property or until production ceased.

At the time of the lease the land was not producing oil and gas; wells had not been drilled. However, respondents, their lessees, and the assignees of the oil payment believed from the outset that the oil payment would pay out within a few years. Respondents stipulated at trial that this belief would be shared by any person of ordinary prudence dealing in mineral lands

[2] An oil payment is "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced", whereas a royalty is not limited to a specified sum of money but is "a right to receive a specified percentage of all oil and gas produced" for the entire term of the lease. *Anderson* v. *Helvering*, 310 U.S. 404, 409–410; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 262.

or mineral leases with knowledge of the facts then generally known or ascertainable upon reasonable inquiry. The oil payment did in fact pay out within the estimated time (R. 22–23).

Respondents reported their share of the gain from the sales of the two undivided interests in the production payment as long-term capital gain for 1956 and 1957 (R. 24). The Commissioner of Internal Revenue determined that the gain was properly reportable as ordinary income, subject to the depletion allowance, and asserted tax deficiencies (R. 3). Respondents paid the deficiencies, filed a timely refund claim, and brought a timely suit for refund against the district director after the refund claim was denied (R. 1–2).

The district court ruled that the gain was capital (R. 104, 106–114), and the court of appeals affirmed (App. *infra.*)

REASONS FOR GRANTING THE WRIT

The ruling below is in conflict with a decision of this Court and decisions of the Court of Appeals for the Fifth Circuit. It creates, moreover, substantial opportunities for improper conversion of ordinary income into capital gain, in a way that would result in inconsistent tax treatment of taxpayers residing in the Fifth and Tenth Circuits.

1. The decision conflicts with *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260. There, five taxpayers carved oil (and sulphur) production payments out of royalty or working interests they owned, and transferred them in consideration of specified cash payments, equivalent

to the value of the transferred production payments. The taxpayers retained royalties or working interests that would continue until the minerals were exhausted or production ceased. As to one taxpayer the Court noted that (p. 262): "At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years." Indeed, as to all five cases the Court stressed (p. 265) that the payout "could be ascertained with considerable accuracy." Thus it was clear that each taxpayer had assigned the right to receive monies that, in his hands, would clearly have been ordinary income.

The Court concluded (p. 264) that "the consideration received for these oil payment rights (and the sulphur payment right) was taxable as ordinary income, subject to depletion". This ruling controls here. The parties have stipulated that respondents and their assignees reasonably believed at the outset that the oil payment would pay out, as it did, within a few years. This was reflected in the assignees' payment of $300,000 cash for a $300,000 oil payment. As in *Lake*, only a fraction of respondents' oil rights were transferred; the balance was retained in the form of a royalty for the life of the mineral property or until production ceased. As this Court said in *Lake* (p. 266):

> The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise

obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

The court of appeals distinguished *P. G. Lake* on the ground that the taxpayers there "conveyed neither the whole nor an undivided fraction of the oil production payment, but rather retained a reversionary interest therein". In fact, however, the taxpayers in *Lake,* like respondents here, did convey all rights to a production payment, while retaining the royalty interest. This Court concluded in *Lake* that there had been no conversion of a capital asset because the taxpayer assigned only a fraction of the more extensive mineral interests it held—a fraction the payout of which could be ascertained with reasonable accuracy. This rationale is equally applicable here, and the court below erred in not so holding.[3]

2. The present decision is also in conflict with two decisions of the Fifth Circuit, *United States* v. *Foster,* 324 F. 2d 702, and *Floyd* v. *Commissioner,* 309 F. 2d 95. Both of these cases involved an assignment of an oil payment by a taxpayer who retained a royalty; in both there was a reasonable expectation of full payout from production. In both the Fifth Circuit, relying upon *Lake,* held that the payments re-

[3] The fact that the production payment in *Lake* was carved out subsequently to the creation of the transferor's working interest while the production payment in this case was created simultaneously with the respondents' royalty is without significance under the rationale of *Lake.*

ceived for the assignments were ordinary income to the assignor, subject to the depletion allowance.

In *Floyd,* as here, the taxpayer was the lessor of oil and gas land, and the lease reserved to him a royalty and a separate oil payment, which he subsequently assigned. The Fifth Circuit held that the assignment generated depletable ordinary income rather than capital gain. *Floyd* v. *Commissioner, supra.*

In form, *Foster* differed. There the lease reserved to the taxpayer and his co-lessors what was termed a 10/24ths "royalty" interest until $220,000 was paid, and thereafter a 5/24ths royalty. The lessors assigned an oil payment (also designated a "royalty") of $110,000 out of 5/24ths of production. In reaching the same conclusion as in *Floyd,* the Fifth Circuit deemed irrelevant the question whether, in a given case, the assigned oil payment was formally or conceptually separate from the retained royalty in the hands of the assignor. The legally significant fact, the court held, is that the oil payment was carved out from the sum of the interests the taxpayer purported to reserve under a single lease. The court reasoned that (324 F. 2d at p. 708):

> in finding that the assigned oil payment was carved out of taxpayer's depletable property interest, all the mineral interests which taxpayer retained underlying this one tract of land and subject to a single lease, under tax law principles, are to be considered as one interest. Prior to execution of the lease, taxpayer and his co-lessors had full, perfect ownership of the land. By leasing it, they created another property interest for the benefit of the lessee, but

> the interest they retained continued as one interest. A landowner conceivably might purport to retain a thousand separate interests, although in reality what he has held back is but one reserved interest with various types of divisions or units. * * *

The court regarded only one other issue as significant—whether there was a reasonable expectation of full payout at the time an oil payment was assigned. If so, the court held, the oil payment is a terminable interest limited to the specified payout—not an interest extending over the entire life of the lease, such as a royalty. Taking into account all of the relevant facts—including the fact that (p. 709) "the purchasers of the $110,000 oil production payment paid $100,882.35 for it, a discount of less than 10 per cent"—the court concluded that the initial expectation of full payment was wholly reasonable. Accordingly, the court held that the considerations for the assignment of the oil payment were ordinary depletable income to the assignors.[4]

In the decision below, the Tenth Circuit sought to distinguish *Floyd* and *Foster*, but the asserted factual distinctions are based on a rejection of the principles underlying the Fifth Circuit's decisions. The court stated that in *Floyd* (App. 14) "there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of

[4] Accord *Estate of Killam*, 33 T.C. 345.

the assigned oil payment contingent upon production". Apparently the court referred to the assignor's agreement to repurchase a portion of the oil payment, at the request of the assignee, if the number of producing wells, 15 at the time of assignment, was not increased to 21. But in *Foster* the Fifth Circuit expressly refused to find that this fact controlled *Floyd* (324 F. 2d at 707): "This agreement did not reduce the transaction to something less than a complete divestiture of ownership of the oil payment."

The attempt to distinguish *Foster* as a case where (App. 13) "the taxpayer sold only a portion of a reserved 'royalty' interest" is directly contrary to the rationale of the *Foster* decision that the transfer of a "royalty" was in substance the transfer of a production payment.

3. The Tenth Circuit, in ignoring the thrust of this Court's decision in *P. G. Lake,* has approved a method that would allow lessors of oil and gas land to secure capital gains on the assignment of production payments, which have been carved out of a larger interest. The Fifth Circuit, another jurisdiction where there is a large amount of oil and gas production, has reached the contrary conclusion in cases indistinguishable from the present one. Thus, the decision below, if allowed to stand, poses an important threat to the revenues, and presents a significant probability that similarly situated taxpayers will receive inconsistent treatment in the Fifth and Tenth Circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1967.

APPENDIX

United States Court of Appeals—Tenth Circuit

(No. 9094—May Term—1967.)

Appeal From the United States District Court for the Western District of Oklahoma

Earl R. Wiseman, Director of Internal Revenue for the District of Oklahoma, appellant

v.

Ralph E. Barby and Marie Barby, Husband and Wife, appellees

Before Murrah, Chief Judge, and Pickett and Hickey, Circuit Judges.

Pickett, Circuit Judge.

This is a tax refund case originating in the United States District Court for the Western District of Oklahoma. The sole question is whether taxpayers' gain from two sales of undivided one-half interests in an oil production payment is taxable as long-term capital gain or as ordinary income. 26 U.S.C. §§ 1221, 1222. Judgment was entered for the taxpayers, Ralph E. and Mary Barby, husband and wife.

The facts are fully stipulated. On November 5, 1956, taxpayers executed oil and gas leases on a large tract of Oklahoma land which they had owned for several years and on which there was then no production. Under the lease agreement, taxpayers reserved a one-eighth royalty interest and a $300,000 oil production payment to be paid out of 90% of the lessee's 7/8ths working interest. On the same day, November 5,

1956, taxpayers sold a one-half interest in the oil production payment to a third party for $150,000. On January 3, 1957, they sold the remaining one-half interest to another party for $150,000, retaining their one-eighth royalty interest.

In their joint returns for 1956 and 1957, taxpayers reported the proceeds from the sale of the oil production payment as long-term capital gain. The Commissioner of Internal Revenue determined that the proceeds from this sale were ordinary income, subject to depletion allowance, and accordingly asserted tax deficiencies for 1956 and 1957. Taxpayers paid the deficiencies, with interest, and filed a refund claim which was denied. Thereupon this action was brought against the District Director.

The District Director asserts that the capital assets here consist of the entire reserved economic interest in the oil in place, so that when taxpayers leased the land and reserved a royalty interest and an oil production payment and then subsequently sold the oil production payment alone, they transferred less than their entire economic interest in the oil in place and therefore did not sell a capital asset, but rather the right to receive future ordinary income. We apprehend no reason for such a broad principle, nor do we think the decisions relied upon sustain the District Director's position.

Primary reliance is placed upon Commissioner v. P. G. Lake, Inc. 356 U.S. 260, rehearing denied 356 U.S. 964. Lake was a corporation engaged in the business of producing oil and gas. It had a ⅞ths interest in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000, and in consideration of his cancellation of the debt assigned an oil payment right (production payment) to him in the amount of $600,000, payable

out of 25% of the oil attributable to its working interest in the two leases. The assignment provided that the conveyance would thereafter terminate and that the interest assigned "shall revert to and revest in the grantor. . . ." It was held that the consideration received for the assignment was taxable as ordinary income subject to depletion allowance, and not as long-term capital gain. It is apparent that the Lake case dealt with a factual situation in which the taxpayer conveyed neither the whole nor an undivided fraction of the oil production payment, but rather retained a reversionary interest therein upon satisfaction of the $600,000 debt. The purchaser received nothing except the right to receive the oil payment until the debt was satisfied. Here, taxpayers disposed of their entire interest in the reserved oil production payment, a property distinct and separate from the royalty interest, and a property in which taxpayers retained no reversionary interest. Other cases cited by the District Director in support of his position are also distinguishable. In United States v. Foster, 5 Cir., 324 F.2d 702, the taxpayer sold only a portion of a reserved "royalty" interest. In Floyd v. C.I.R., Cir., 309 F.2d 95, there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of the assigned oil payment contingent upon production. In Estate of Killam, 33 T.C. 345, the taxpayer sold only the first of two successive oil payments which he had reserved. In Floyd and Killam, as well as Lake, there was production from the property at the time of the assignment, and this production could be applied to pay-out the assigned oil payment.

The retention of an economic interest in oil property is not necessarily dispositive in every case where the question arises as to whether the proceeds from

a conveyance of rights therein shall be treated as capital gain or as ordinary income for tax purposes. Cf. United States v. White, 10 Cir., 311 F.2d 399. It is the substance and effect of the entire transaction which must be examined. United States v. Foster, supra. Here, the oil production payment was wholly separate and distinct from the royalty interest, neither being dependent upon, carved out of, or affected by the other, save that separate interests had been reserved by taxpayers out of their entire interest in the oil in place prior to the lease. Cf. Herndon Drilling Co., 6 T.C. 628, 637. The sale of the oil production payment is a complete disposition of interest and may not properly be characterized as a mere present assignment of anticipated future ordinary income as in Wiseman v. Halliburton Oil Well Cementing Co., 10 Cir., 301 F.2d 654, and Dyer v. C.I.R., 10 Cir., 294 F.2d 123. Cf. United States v. White, supra; United States v. Dresser Industries, Inc., 5 Cir., 324 F.2d 56; Caldwell v. Campbell, 5 Cir., 218 F.2d 567. The sale of each undivided half of the oil production payment constituted a complete disposition of taxpayers' entire property interest therein and therefore was a sale of a capital asset under 26 U.S.C. § 1221.

The District Director further contends that even if taxpayers' oil production payment is treated as a capital asset, the taxpayers nevertheless are not entitled to long-term capital gain treatment because the oil production payment, created by the lease of November 5, 1956, was not held for six months before it was sold. It is stipulated, however, that the property from which the oil production payment was created had been owned by taxpayers for several years prior to the sale of the oil production payment. The execution of the oil and gas lease providing for the oil pro-

duction payment created no new rights in the taxpayers. United States v. Foster, supra., Fn. 8. Cf., Alice G. K. Kleberg, 2 T.C. 1024, 1031. Under these circumstances, the six month holding period required by 26 U.S.C. § 1222 was satisfied and the taxpayers are entitled to treat the proceeds from the sale of the oil production payment as long-term capital gain.

AFFIRMED.

JUDGMENT

Before MURRAH, Chief Judge, and PICKETT and HICKEY, Circuit Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Oklahoma and was argued by counsel.

On consideration whereof it is ordered and adjudged by this court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

Dated: July 5, 1967.

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OCTOBER TERM, 1967

No. 871

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OKLAHOMA,
Petitioner,

vs.

RALPH E. BARBY AND MARIE BARBY,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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IN THE

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EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OKLAHOMA,
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Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RALPH E. BARBY AND MARIE BARBY, IN OPPOSITION

OPINION BELOW

The opinion of the Court of Appeals (Pet. App. 1-17) is reported at 380 F.2d 121.

JURISDICTION

The judgment of the Court of Appeals was entered on July 5, 1967. (App. 17). By order dated September 29, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including December 2, 1967. Mr. John F. Davis, Clerk, extended the time for filing a brief in Opposition to said petition to February 21, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

The question as presented by Petitioner "is whether the $300,000.00 received for the assignment of the production payment was capital gain, as the Court below held, or ordinary income subject to the depletion allowance, as petitioner contends."

More precisely stated, four questions demand attention:

1. Did said production payment so reserved by respondents constitute a "mineral property", separate and independent of the traditional one-eighth royalty interest similarly reserved by them?

2. If said production payment did constitute a separate mineral property reserved by respondents, did it also constitute a capital asset in their hands?

3. If said production payment constituted a separate mineral property, and, in respondents' hands, a capital asset, did the two separate sales of undivided half interests therein result in long-term capital gain to respondents?

4. Does the ruling below conflict with a decision of this Court (*Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260),

or decisions of the Court of Appeals for the Fifth Circuit (*United States* v. *Foster*, 324 F.2d 702, and *Floyd* v. *Commissioner*, 309 F.2d 95), as asserted by petitioner?

STATUTES INVOLVED

Internal Revenue Code of 1954:

Sec. 614: DEFINITION OF PROPERTY.

"(a) *General Rule.*—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

"(b) SPECIAL RULES AS TO OPERATING MINERAL INTERESTS IN OIL AND GAS WELLS.—In the case of oil and gas wells—

"(1) IN GENERAL.—Except as otherwise provided in this subsection—

"(A) All of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and

"(B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land."

* * *

Sec. 1221. CAPITAL ASSET DEFINED.

"For purpose of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;"

* * *

Sec. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

* * *

"(3) LONG-TERM CAPITAL GAIN—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income."

* * *

(26 U.S.C. 1964 ed., Sec. 1221, 1222, 614.)

STATEMENT

Respondents had, for many years, owned land from which there was no oil and gas production, though recently deemed by them and Cabot Carbon Company to be potentially productive. On November 5, 1956, respondents leased this land to Cabot, reserving, in addition to the usual one-eighth (1/8) perpetual royalty interest, "as a separate and distinct property interest, an undivided ninety percent (90%) of seven-eighths (7/8) of all oil, gas and other hydrocarbons in and under and that may be produced, and saved from * * *" said lands "until from the proceeds of the oil, gas and other hydrocarbons ac-

cruing to the Production Payment Interest, if, as and when produced, saved, and sold, lessors, their heirs, successors and assigns shall have received the aggregate of (1) the full net sum of $300,000.00 in cash, plus (2) an amount equal to interest at the rate of 5 1/2% per annum on the unliquidated balance * * *." If, as and when such total sum had been received, said Production Payment Interest terminated. (R. 27). In addition, respondents, with other joint land owners, received a cash lease bonus of $25,000.00, which they returned as ordinary income. (R. 109, Par. 20).

On the same day said lease was made, respondents conveyed an undivided one-half (1/2) of said Production Payment Interest in an arms length transaction (R. 109, Par. 19), to Eby, Inc., for a cash consideration of $150,000.00. (R. 39-44).

On January 3, 1957, respondents conveyed the remaining undivided one-half (1/2) of said Production Payment Interest, in another arms length transaction (R. 109, Par. 19), to Tokay Oil Company for a cash consideration of $150,000.00. (R. 45-49). Respondents reported each of said conveyances as the sale of a capital asset; reported a capital gain thereon; and paid their income tax applicable thereto. (R. 24). Petitioner determined said gains to be taxable as ordinary income and asserted tax deficiencies (R. 3) which were subsequently paid by respondents, who then filed timely claims for refund; and upon denial thereof by Petitioner, timely filed a suit for refund. (R. 1-2). Petitioner admits there was no collusion between the taxpayer, the lessee and the purchasers of said Production Payment Interest and that there was no scheme to conceal a large bonus. (R. 109-110, Par. 23).

The District Court ruled that respondents reserved two separate mineral interests from the lease conveyed to Cabot Carbon Company, both constituting royalty interests:

(1) One in perpetuity (the traditional landowners royalty); and

(2) One limited in duration (the Production Payment Interest);

that each such mineral interest was neither dependent upon, nor in any sense qualified, limited or affected by the other mineral interest; that the sale of the Production Payment Interest, in undivided halves, constituted the sale of a capital asset; and that the gain from said sale constituted a long-term capital gain. (R. 110, Pars. 1, 2, 3, 4).

The Court of Appeals affirmed, distinguishing the case, on its facts, from *Commissioner* v. *P. G. Lake, Inc., supra; U. S.* v. *Foster, supra; Floyd* v. *Commissioner, supra;* and *Estate of Killam*, 33 T.C. 345. (Petitioner's Appendix, 11-15).

ARGUMENT

1. Did respondents' reserved production payment constitute a mineral interest separate and apart from their reserved, traditional one-eighth (1/8) perpetual royalty interest of a landowner?

No question has been raised concerning respondents' ownership of the retained one-eighth (1/8) royalty interest constituting an interest in minerals. Such status is therefore conceded.

We pass then to the question: Did respondents' reservation, also, of "an undivided ninety percent (90%)

of 7/8 of all oil, gas and other hydrocarbons" of a value of $300,000.00, similarly constitute a separate and distinct interest in the minerals?

That such a reserved production payment does constitute such an interest in minerals is universally attested by numerous decisions of this Court; by many lower federal courts; by the legislative history leading up to and culminating in the definition of a mineral property in Section 614 (a) of the Internal Revenue Code, *supra;* and by formal regulations, rulings and memoranda of the United States Treasury Department.

In the opening paragraphs of *Commissioner* v. *P. G. Lake, Inc., supra,* Justice Douglas, speaking for this Court, stated:

> "The Court of Appeals started from the premise * * * that oil payments are interests in land. We, too, proceed upon that premise." (Page 264).

This Court, in *Anderson* v. *Helvering,* 310 U.S. 404, in distinguishing the status of the taxpayer there, who held adequate security for the payment of the balance of the sales price over and above that of a holder of a simple oil payment right with its characteristics, stated with reference to the value of the latter:

> "* * * yet it (the oil payment right) does depend upon the production of oil * * *. Accordingly, this Court in Thomas v. Perkins (301 U.S. 655) decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. The decision did not turn upon the particular instrument involved, or upon the formalities

of the conveyancer's art, but rested upon the practical consequences of the provision for payment of that type." (Page 410).

In *Palmer* v. *Bender*, 287 U.S. 551, this Court, in delineating the respective rights to oil of both the lessor (who had reserved an oil payment of $1,000,000.00 from the lease) and the lessee, stated with reference to the rights of the reserving lessor:

> "It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced If so, he has an economic interest in the oil, in place * * *." (p. 557).

Lower federal courts, including the Court of Appeals for the Fifth Circuit, universally follow the above outlined reasoning of the Court in recognizing the interest of a lessor, who has reserved an oil or gas payment, as the owner of a mineral property:

Caldwell v. *Campbell*, 5 Cir., 218 F.2d 567;

T. L. Lee v. *Commissioner*, 5 Cir., 126 F.2d 825;

Ortiz Oil Co. v. *Commissioner*, 5 Cir., 102 F.2d 508;

Fleming v. *Commissioner*, 5 Cir., 82 F.2d 324;

Williams v. *Commissioner*, 5 Cir., 82 F.2d 328;

Holly Development Co. v. *Commissioner*, 9 Cir., 93 F.2d 146.

The United States Treasury Department has, for over a half century similarly recognized a production payment right (which is solely dependent upon production of oil and gas), as an interest in a mineral property, separate and apart from any other type of interest he may own in such property.

As a matter of historical fact, the United States Treasury Department has consistently ruled that if a taxpayer owns more than one interest,

> "in the same tract or parcel, each interest is a 'property' within the comprehension of that term as used in the provisions of the Revenue Acts fixing a basis for the computation of depletion. As the basis fixed also governs the computation of gain or loss, it follows that a depletable 'property' is also an asset subject to sale or other disposition giving rise to gain or loss. Accordingly, each such interest must be treated as a separate 'property' for income tax purposes. Failure to treat each such separate interest as a separate property would disregard or unduly confuse the administration of the provisions of the Revenue Acts requiring the computation of gain or loss upon the sale of an asset and the provisions distinguishing between ordinary income and capital gain or loss taxable at different rates * * *." G.C.M. 22106, C.B. 1941-1, 245-250, at page 246.

Substantially the same provisions are found in the following:

G.C.M. 22730, C.B. 1941-1, p. 214;

G.C.M. 24094, C.B. 1944, pp. 250-255;

G.C.M. 24849, C.B. 1946-1, p. 66;

Treasury Regulations 74, Article 221 (1929);

Treasury Regulations 77, Article 221 (j);

Treasury Regulations 86, Article 23 (m)-1 (j), (1934).

Finally, the Congress codified such Treasury construction into a statutory definition of interests owned in a mineral property in Section 614, Internal Revenue Code of 1954 (26 U.S.C., 1964 ed., Sec. 614), *supra*. To clarify its meaning of terms used in said Section, the Senate Finance Committee made the following statement:

"This section corresponds to section 614 of the bill as passed by the House, and has no counterpart in the 1939 Code. It provides a statutory definition of the term 'property' for purposes of computing the depletion allowance in the case of mines, wells, and other natural deposits. Present law contemplates that the depletion allowance shall be computed by properties, but provides no definition of 'property'.

"Section 614 (a) is identical with the corresponding provision as passed by the House. It provides a general rule which states that for the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. For purposes of this definition tracts or parcels may be separated by conveyancing as well as geographically."

(Senate Report No. 1622, 83rd Congress, 2d Session 333 (1954).

Continuing, said report provided:

"Your committee has amended section 614 (b) (1) to provide that an aggregation adopted under this section shall be effective for all purposes of the income tax subtitle, and is not limited to the computation of percentage depletion, as under the House bill. The effect of this amendment is to make the definition of property consistent so as to be applicable to the computation of both cost and percentage depletion, and to the computation of gain or loss upon a sale or exchange."

Treasury Regulations, paragraph 1.614-1, issued under said Section 614 of the Internal Revenue Code of 1954, provided in applicable part, as follows:

"(a) General rule.—(1) For purposes of subtitle A of the Code, in the case of mines, wells and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

"(2) The term 'interest' means an economic interest in a mineral deposit. See paragraph (b) of Sec. 1.611-1. The term includes working or operating interests, royalties, overriding royalties, production payments and net profits interests."

Said Regulation continues and provides, in applicable part, as follows:

"(b) Separation of interests treated as 'single property' under prior regulations. * * * Each separate mineral interest which, in accordance with paragraph (a) of this section, is separate property shall be so treated, notwithstanding the fact that the taxpayer under paragraph (i) of Sec. 39.23 (m)-1 of this chapter (Regulations 118) and corresponding provisions of prior regulations may have treated more than one of such interests as a 'single property'."

This same statement appears today in the current Treasury Regulations as the same Section No. 1.614-1 (b).

From the foregoing history of Regulations, Rulings, Interpretations, and finally, statutory construction represented by Section 614 of the Internal Revenue Code of 1954, which is still the law today, it is abundantly clear that the Treasury Department and the Congress have considered the term "property" to mean and include each separate interest (including oil payments) owned by the taxpayer in each mineral deposit in each separate tract of land.

Furthermore, it is clear that the Senate Finance Committee, in its aforementioned Report on Section 614 of the

Internal Revenue Code of 1954, recognized that such interests may be "separated by conveyancing as well as geographically". (Senate Report No. 1622, *supra*).

In the instant case, the agreed facts are that taxpayers, then owners in fee of the land involved, reserved two separate mineral interests therein, when they executed the subject lease to Cabot Carbon Co., Inc. (Joint Ex. A, Sec. 3 and 4, R. 25-27):

1. The usual 1/8 royalty interest of a fee owner, and
2. An undivided 90% of 7/8 of all oil, gas and other hydrocarbons in and under said leased lands, until an amount equivalent in value to $300,000.00 plus an interest factor, was recovered.

Appellant is in the anomalous position of here maintaining that the retained oil payment is not a mineral property, when the Government has consistently, for a period of more than a half century, steadfastly maintained just the opposite, i.e., not only for depletion purposes, but for the purposes of determining gain or loss upon the sale of mineral interests:

> "if a taxpayer holds several interests in the same tract or parcel, each interest is a 'property' within the comprehension of that term as used in the provisions of the Revenue Acts fixing a basis for the computation of depletion. As the basis fixed also governs the computation of gain or loss, it follows that a depletable 'property' is also an asset subject to sale or other disposition giving rise to gain or loss." (G.C.M. 22106, C.B. 1941-1, pp. 245-250.)

The Tax Court has recognized the principles herein advanced by Respondents, and in a 1946 opinion, *Herndon Drilling Co.*, 6 T.C. 628 (1946), clearly stated the law ap-

plicable to the instant case. There, the taxpayer had acquired both an undivided one-half (½) interest in:

1. the working interest and
2. an oil payment payable with six percent (6%) interest out of the other one-half (½) of the working interest.

The oil payment was to terminate at such time as taxpayer had recovered an amount equal to certain expenditures previously made by taxpayer. In such case, taxpayer was attempting to combine both mineral properties as one. The Goverment, however, contended that said interests were separate; directly contrary to its contentions in the instant case.

In holding that taxpayer's two interests in the mineral property each constituted "a separate capital asset", the Court set forth principles we believe most persuasive in the case at bar, when it stated:

> "We think that under the facts here, the two interests in each lease must be held to be two properties, and we so hold. They are inherently separate and different in character. One is an outright ownership in fee of an undivided part of its leasehold estate. The other, is less than a fee title interest in the remaining undivided part of the leasehold. There is no merger of the titles to the two interests. See GCM 24094, 1944 CB 250, CF Wm. H. Cree, 47 BTA 868."

Continuing, the Court stated:

> "Not only was it realistic and practical for petitioner to treat the two interests as separate properties, as was done in Black Mountain Corporation, 5 TC 1117, but it was under a legal obligation to so treat them in recording expenditures and income."

As the foregoing history leading up to the enactment of Section 614 of the Internal Revenue Code of 1954 discloses, the framework of the law as it existed at the time of Herndon was not materially different than the principles codified by the passage of said Section 614.

It is therefore respectfully submitted that the Herndon principles, augmented by the legislative history set forth above, control the present controversy. Here, as there, the taxpayers retained two distinct "interests"—one an "outright ownership in fee" of a royalty interest, the other something less than a "fee title interest". There could be no merger of titles for the one interest continues for the duration of production, while the other may terminate long in advance of the cessation of production. Here, also, as there, the production attributed to each of the separate interests would require separate accounting for the one terminates after an amount of production equalling a specified dollar amount has been allocated to such separate interest. Only by treating the interests separately can the termination point of the one interest be determined.

Although GCM 24849, 1946-1 C.B. 66, I.T. 3895, 1948-1 CB 39, and I.T. 4003, 1950-1 C.B. 10, were issued in the years 1946, 1948 and 1950, respectively, there had been no judicial sanctions of such attempted changes in policy of the Treasury Department prior to the passage of the Internal Revenue Act of 1954, effective as of August 16, 1954. (Title 26, U.S.C. 614, *supra*).

That an oil payment is a mineral "property" has not only been established by a half century of administrative practice and treatment by the Government itself as above outlined, but also by Federal Courts in their recognition of a production payment interest as constituting an "economic interest", and as an interest in oil and gas, in place, in numerous cases.

II. Did said production payment interest constitute a capital asset in the hands of respondents?

We address this section to the simple proposition, namely, that such reserved oil payment constituted a capital asset within the intent of the Federal Internal Revenue Code.

Because this is a fundamental question, we deem it advisable to trace the history of the capital asset provisions of the Internal Revenue Code from their inception in the Internal Revenue Code of 1921; therefore, a concise history of said capital asset provision from the 1921 Internal Revenue Code to what now appears as Section 1221, 26 U.S.C., 1964 ed., Section 1221, follows:

Section 206 (a) of the 1921 Internal Revenue Code read as follows:

> "(6) The term 'capital assets' as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock or shares in a corporation, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

The purpose and coverage of said definition was succinctly summarized by the House Ways and Means Committee Report (67th Cong., 1st Sess. H. Rept. 350), which reads, in applicable part, as follows:

> "Section 206. The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump

sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section * * * to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 percent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 percent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

Such purpose was likewise evidenced by the U. S. Senate as reflected by the Senate Finance Committee in its Report (67th Cong., 1st Sess. Rept. 275), which in applicable part, reads as follows:

"Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 percent of the net gain derived from the sale or other disposition of capital assets will be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 percent."

The concept of the term "capital assets" as above defined in the 1921 Revenue Act, has been continued basically through successive Revenue Acts into the Internal Revenue Code as it exists today, refined only in the following aspects:

1. Whereas the 1921 Act definition covered property acquired and held by the taxpayer for profit and investment, Section 1221 of the present Internal Revenue Code covers simply "property held by the taxpayer."

2. The exceptions contained in the 1921 Act have been increased to exclude:

a. Copyrights, literary and music or artistic compositions, etc., (Sec. 1221 (3).)

b. Accounts and notes receivable acquired in the order or course of trade or business (Sec. 1221 (4).)

c. Obligations of the U.S., etc., issued on a discount basis. (Sec. 1221 (5).)

None of said additional exceptions are applicable in the present case.

3. An analysis of the essence of the statutory definition of capital assets shows, as it now appears, that capital assets include all property held by the taxpayer (whether or not connected with his trade or business) except:

a. Stock in trade (or inventory) or property held by the taxpayer primarily for sale in the ordinary course of taxpayer's trade or business;

b. Property used in the trade or business subject to depreciation or real property not used in his trade or business;

c. Copyrights;

d. Accounts and notes receivable acquired during the ordinary course of business;

e. Obligations of the U.S. or political subdivisions issued at a discount, and payable without any interest.

Further evidence of the Congressional intent is shown by the Report of the Senate Committee on Finance, Sen. Rept. 1631, which accompanied H.R. 7378, with respect to reducing the holding period of capital assets from twenty-four to six months in the determination of capital gains and losses, wherein said Committee felt that lowering of the holding period would have the effect of encouraging realization of capital gains and would therefore result in added revenue. Furthermore, that Committee felt that a six months holding period was a sufficient deterrent to speculators who might otherwise profit by the shorter holding period. 77 Cong., 2nd Sess. (1942), Sen. Rept. 1631.

It is therefore abundantly clear that the oil payment reserved by respondents in this case does not appear as one of the exceptions within the definition of the term; and therefore, it must be classed as a capital asset unless the plain provisions of the statutes are ignored and the Courts substitute their own definition of a capital asset.

An excellent treatment of this particular problem appears in 69 Harvard Law Review 985-1019, in an article by Mr. Stanley S. Surrey, then Professor of Law, Harvard Law School, and presently serving as Assistant Secretary of the United States Treasury. In contrasting the problem faced by Congress in taxing capital gains at a lesser rate than ordinary income, Mr. Surrey, at page 988, states as follows:

"The advantage is so great that the courts have in some cases attempted to produce a more reasonable

> situation by refusing to consider the term 'property' as being here used by Congress in the normal all-inclusive sense in which it is used elsewhere in the Code. This judicial construction, however, in essence amounts in these situations to forgetting about the statutory definition and substituting instead a judicial concept."

Mr. Surrey, after analyzing the decision in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), one of the principal cases relied upon in the court below by Appellant in this case, in which the court held that the dealing in corn futures by that taxpayer was not separate and apart from its manufacturing operation, and therefore such corn futures did not constitute capital assets as to that particular taxpayer, stated:

> "The Court thus resolved the dilemma by placing the congressional definition of section 1221 gently to one side and then deciding the case on its own concept of the capital gain-ordinary income division between investment and business." (p. 993).

Mr. Surrey then called attention to the decision of the Court of Appeals for the Second Circuit, *Commissioner* v. *Bagley & Sewall Co.*, 221 F.2d 944 (1955), in which the Court allowed ordinary loss sustained upon the sale of United States Government bonds required to be deposited for security of performance by a contractor having a contract with a foreign government; and to the decision of the Tax Court of the United States, *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955), wherein the Court allowed an ordinary loss on the sale of debentures, such debentures having been purchased by the taxpayer in need of sources of supply from a newly formed lumber company, which later failed.

In *Commissioner* v. *Bagley & Sewall Co., supra,* the Government itself had argued that the bonds there involved must be treated as capital assets unless exempted by the specific language of the section. The Court, however, held that the taxpayer intended no investment, and thus, as to the particular taxpayer in that particular factual situation, the Government bonds so held did not constitute capital assets.

In *Tulane Hardwood Lumber Co., supra,* the Court similarly held that the loss sustained in the particular circumstances "was proximately related" to the conduct of its business and that said debentures did not constitute a capital asset.

Contrasting the three cases, *Corn Products Refining Co., supra; Comm.* v. *Bagley & Sewall Co., supra,* and *Tulane Hardwood Lumber Co., supra,* Mr. Surrey then asked this question:

> "Under these decisions is there any escape from wild uncertainty? If the courts are to embark on a search for the reasons why individuals or corporations buy stocks or securities and to weigh whether an 'investment' motive is overbalanced by some other motive, many a stock or security can become an ordinary asset but no one will be able to predict when the transformation will take place." Ibid p. 999.

In the instant case, respondents were fee owners of lands. They were not engaged in the oil and gas business, nor engaged in the selling of oil and gas interests, but were partners in the Barby Cattle Company, a ranch partnership which owned and operated some 23,851 acres of land. (R. 2, par. 7).

The mineral interests here involved constituted only a portion of the entire interest, namely, surface and minerals (a fee interest).

As to respondents, the entire mineral interests owned just prior to the subject lease, constituted "property held by the taxpayer" as defined by Section 1221 and such property does not fall within any of the specific exemptions enumerated in the said section.

The reserved oil payment right, as well as the reserved one-eighth royalty interest, each, therefore, fall within the plain provisions of Section 1221, and each constituted a separate capital asset in this particular case in the hands of these particular taxpayers.

III. Did the two separate sales of undivided half interests in said production payment interest result in long-term capital gain to respondents?

The Court found in *P. G. Lake, Inc., supra* (principally relied upon by Appellant), that each of the five taxpayers involved retained an interest in the oil payment assigned, neither having parted with the whole, nor a fraction extending over the life of the property sold. On this point, it quoted from I.T. 4003 (1950-1, CB 10, 11) in part as follows (Footnote No. 5):

> "Notwithstanding the foregoing, GCM 24849 (1946-1) (Cum. Bul. 66) and I.T. 3895 (1948-1 Cum. Bul. 39) do not apply where the assigned oil payment right constitutes the entire depletable interest of the assignor in the property, or a fraction extending over the entire life of the property."

Here, taxpayers' assignment, as of November 5, 1956, was of an undivided interest of the entire reserved oil payment. Likewise, its assignment on January 3, 1957, was of the remaining undivided one-half (½) in said oil payment. Each transaction falls specifically within the exception noted by the Court in the Lake case.

In neither such sale did taxpayers retain a reversionary interest, but in each case, sold a fraction extending over the life of the oil payment. Therefore, the exception noted in the Lake decision is wholly applicable here.

IV. The ruling below neither conflicts with the decision of the Court in Comm. v. P. G. Lake, Inc., supra, nor the following decisions of the Court of Appeals for the Fifth Circuit: United States v. Foster, supra, and Floyd v. Commissioner, supra.

Appellant's entire premise under its "Reasons for Granting the Writ", beginning on page 4 of its Petition for a Writ of Certiorari, we submit, is bottomed upon erroneous conclusions. *Commissioner* v. *P. G. Lake Co., Inc., supra,* dealt with factual situations in which the respective taxpayers neither conveyed (1) the whole, nor (2) an undivided fraction of the mineral interest owned by them prior to the assignments involved. (3) Furthermore, all said mineral interests had been carved out of producing properties from which the "pay-out—could be ascertained with considerable accuracy", and this Court found that "the substance of what was assigned was the right to receive future income." Here, respondents made two sales of a complete fraction of an oil payment (an undivided one-half) in a non-producing property. Each sale thus fell within the exception set forth in I.T. 4003, *supra,* as recognized and quoted with approval in *Lake, supra.* Further, as in *Corn Products Refining Co., supra,* there is a striking parallel in the relationship of dealing in corn futures to the principal business of that company, in that here, as there, this Court found, "Lake is a corporation engaged in the business of producing oil and gas", whereas here, respondents were ranchers and not, in any wise, engaged in the oil and gas business.

In *United States* v. *Foster, supra,* the taxpayer sold only a portion of a reserved "royalty interest". In *Floyd* v. *Comm., supra,* there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of the assigned oil payment contingent upon production.

In *Estate of Killam, supra,* the taxpayer sold only the first of two successive oil payments which he had reserved. In Floyd and Killam, as well as Lake, there was production from the property at the time of the assignment, and this production could be applied to pay-out the assigned oil payment. Further, in none of the above cases, was the Court supplied with the legislative history, above set forth, of the recognized definition of a "mineral property".

Even the theory adopted by the Court in the *Floyd* case, *supra,* was seriously questioned by Circuit Judge Wisdom in a strong dissenting opinion, in which he stated:

> "In each of the five Lake cases there was a carved out oil payment in a single property from which the oil payment was to be satisfied; and the property was assigned for the period necessary to satisfy the payment, and thereafter reverted to the assignor. Here, there is no reversion. Here, the royalty interest and the production payment are two distinct, different, separate interests. The production payment does not bear on the overriding royalty interest; the taxpayer will have that interest as long as the lease is in effect and it is payable without limit as to amount. This concept of an oil interest as a separate property distinct from other interests in the same tract has been the established view of the Treasury for many years. See U.S. Treasury Regulations, Section 1.614-1; Regulations 111, Section 29.23(m)-1(i); GCM 22106, 1941, CB 245; GCM 24094, 1944 CB 250. As I read Lake, the decision does not apply to a taxpayer's as-

signment of his entire interest in a distinct property, separate from the royalty interest and to which the assignor has no right of reversion." (p. 96).

Judge Wisdom then ended with these prophetic words:

> "I am concerned over the disruptive effects likely to be produced if Lake is applied mechanically, indiscriminately, sweepingly, whenever the owner of an interest of any sort in minerals makes any kind of conveyance by which he still retains any sort of interest in those minerals. The Commissioner seems to be saying that in every case the assignor has made a leasing or sub-leasing transaction, not the sale of a capital asset or capital investment. On the facts before us, I would hold that the taxpayer's sale of the production payment was not an anticipatory assignment of future income taxable as ordinary income." (p. 96).

Although, as stated by Appellant, the Supreme Court has made it clear that in the field of oil and gas taxation, local law characterization of interests in property are not controlling, yet it has also held that property rights are determined by local law:

Blair v. *Commissioner*, 300 U.S. 5;

Poe v. *Seaborn*, 282 U.S. 101;

Hoeper v. *Commissioner*, 284 U.S. 206.

Here, we are not concerned with the federal law as applied to the production of oil and gas income, but rather to the taxation of gains derived from the sale of a mineral property and of the application of the federal law to the gain derived therefrom.

As we have shown, this oil payment was a capital asset within the definition thereof by Congress in Section 1221. Taxpayers disposed of their entire interest in two

separate sales of said capital assets. They had held the same for more than six months, and thus the gain from the sale thereof is taxable, as Congress intended, under the capital gain provisions of the federal law.

Appellant's argument in "Reasons for Granting the Writ" of his Petition, is a continuity of his argument that the oil payment right here involved was not a capital asset, but represented simply a right to receive ordinary income, primarily under the theory of *P. G. Lake, Inc., supra.*

As we have shown in paragraphs I and II, respondents' oil payment constituted a separate mineral property and was a capital asset under Section 1221 of the Internal Revenue Code.

In actual effect, Appellant is attempting to do what the Government unsuccessfully contended for in the case of *U. S.* v. *Dresser Industries, Inc.*, 324 F.2d 56, 5 Cir. (1963); that position was succinctly stated by Circuit Judge Cameron, speaking for the Court, as follows:

> "The government contends, first, the right assigned or transferred in 1957 was not 'property' or a capital asset, but was 'nothing more' than a substitute for ordinary income to the 'selling party'; and second, that 'even assuming arguendo that a capital asset was here involved, there was no sale or exchange of that asset.'" (p. 57).
>
> "The government makes the customary broadside attack on the sale by citing the usual three cases: Corn Products Co. v. Commissioner, 1955, 350 U.S. 46, 47 AFTR 1789; Commissioner v. P. G. Lake, Inc., 1958, 356 U.S. 260, 1 AFTR 2d 1394; Commissioner v. Gillette, 1960, 364 U.S. 130, 5 AFTR 2d 1770, attempting to demonstrate that their holdings are dispositive of this case." (pp. 57-58).

Judge Cameron distinguished this case as he had in *Nelson Weaver Realty Co.* v. *Commissioner*, 1962, 5 Cir., 307 F.2d 897, 10 AFTR 2d 5569:

> "In Corn Products * * * the Tax Court * * * the Court of Appeals * * * and the Supreme Court found specifically that the taxpayer regularly dealt in corn futures as part of its everyday business operations and that they were, judicially, excluded from the definition of capital assets." (p. 58).

Judge Cameron then distinguished the Lake case by pointing out that Lake kept a reversionary interest in the property sold, the purchaser received nothing but a right to payments, said payments to terminate upon the receipt by the purchaser of $600,000.00 plus a 3% interest thereon. He stated therefore that what was sold by Lake was the right to receive money in the future whereas here, the taxpayer "is cutting off a vertical slice of its rights, rather than carving out an interest from the totality of its rights under the grant. The interest transferred was not to terminate when a certain amount was paid, as was so in Lake, and taxpayer retained no reversionary interest in the 'exclusivity' feature transferred. The tree was sold, along with the fruit, at least insofar as that branch was concerned."

Judge Cameron, continuing, distinguished the Gillette Motor Co. case by observing that the question there concerned the nature of compensation that company had received for the temporary taking by the Government (for about ten months during World War II) of its business facilities, for which the Motor Carrier Claims Commission allowed a determined sum of money for the use of Gillette's facilities at a fair rental rate. Judge Cameron pointed out further that such temporary taking by the

government of private facilities merely produced what was, in effect, rent which is usually considered ordinary income; whereas, here, the transfer involved was both permanent and final.

In further discussion of the far-reaching effect of the Lake decision, (as reflected in *United States* v. *Eidson*, 1962, 5 Cir., 310 F.2d 111), if its premise is applied in any case in which money paid represents the present value of future income to be earned should always be taxed as ordinary gains, Judge Cameron stated:

> "The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income."
>
> "At common law, the right to receive income from land was ownership of the land. Lord Coke said: 'If a man seized of land in fee by his deed granteth to another the profits of these lands, to have and to hold to him and his heirs, and maketh livery secundum formam chartae, the whole land itself doth pass. For what is land but the profits thereof? Co. Lit. 45.
>
> "There is, in law and fact, a vast difference between the present sale of the future right to earn income and present sale of the future right to earned income. If an asset will not in the future be useful, or capable of earning income, it is worthless in the business world.
>
> "We conclude, therefore, that the sale was not merely the present sale of the right to earned income, to be paid in the future. Taxpayer had an asset, a right, a property which would produce income. The fact that

the income which could be earned would be ordinary income is immaterial; such would be true of the sale of all income producing property. See Commissioner v. Ferrer, 1952, 2 Cir., 304 F.2d 125, 9 AFTR 2d 1651, especially the discussion beginning in the last paragraph on page 132." (p. 59).

Judge Cameron then distinguished the opinion of the Court in *Wiseman* v. *Halliburton Oil Well Cementing Co.*, 10 Cir., 1962, 301 F.2d 654, by observing that although the facts appeared similar, nevertheless it was plain in the Halliburton case that the taxpayer, prior to the transaction involved, had the right to sublicense the patent to third parties for a fee; that it gave up that right in return for a share of royalties to be received by the patent owner by licenses to be granted to third parties, and pointed out that that was not the case in Dresser. He then surmised that in the Halliburton case the taxpayer merely substituted the right to receive ordinary income from one source for the right to receive ordinary income from another, which clear distinction is evident from the facts in both cases.

Further, Circuit Judge Brown in a concurring opinion in *U. S.* v. *Dresser Industries, Inc., supra*, gave a very lucid delineation of the distinction in the nature of ordinary income from capital gain:

"Running through several of our prior opinions is the asserted concept that capital gains versus ordinary income is to be determined by the status of current earnings were the asset to have remained in the hands of the transferor. On this approach it is reasoned that if the current income would have been taxable ordinary income, then the sales price which represents the substitute for such future earnings is likewise taxable ordinary income.

"I think this is both bad economics and faulty law. A person acquires property for one of two, or both reasons. The first is to receive earnings, i.e., income. The other is to hold the property for appreciation resulting from long or short range economic conditions, inflation or the like. Normally, of course, the predominant reason is to acquire the earning capacity represented by the earnings which the property will generate.

"Hence it is that among those who trade in corporate securities on established national exchanges or over-the-counter markets, there are recognized rules of thumb by which the present value, hence market price, is determined for a given stock. The same is true in the contemporary, frequent practice of a large-scale corporate acquisition by one corporation of the stock or assets of another corporation. Value—market or sales price—is determined by capitalizing earnings. Whether the formula is the conservative one of 6 or 7 times earnings, or something less, or one considerably more speculative, what the buyer offers is his estimate of the present, discounted value of the future earnings of the assets or enterprise.

"But although this sales price is determined by future earnings, and to the seller it takes the place of what he would have received had he continued his ownership, under no stretch of the imagination is it 'ordinary income', either in the business world or in the sometimes more weird, tax world. Were this so, then every such sale for a price in excess of cost would entail this analysis and this tax consequence."

"Conceding that Congress might compel this, that the ubiquitous and voracious tax gatherer might demand it, or that courts might ultimately sustain it, the fact is that as yet none has gone so fast so far. * * * Tax law, by the hand of man, the Acts of Congress, and the doubtful clarification by Judges is complex enough without making it more so through the importation of

> bad economics. For before we realize it, economics, which knows no law of stare decisis, is infected by poor or bad law to set in train tax consequences because of what Courts have said, not because of what the actualities really are." (pp. 61-62).

We submit, therefore, that as in *U. S.* v. *Dresser Industries, Inc., supra,* respondents here clearly had "an asset, a right, a property" (the oil payment interest); that when that right was sold, a capital gain occurred.

CONCLUSION

For the reasons above set forth, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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February, 1968.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967.

No. 871

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OKLAHOMA,
Petitioner,

vs.

RALPH E. BARBY AND MARIE BARBY,
Respondents.

PETITION FOR REHEARING OF DECISION RENDERED MARCH 11, 1968

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vs.

RALPH E. BARBY AND MARIE BARBY,
Respondents.

PETITION FOR REHEARING

NOW COME the Petitioners, RALPH E. BARBY and MARIE BARBY, and by their counsel, and respectfully pray for a rehearing of this case before a full bench. This Petition is made because Petitioners believe the case of *Commissioner of Internal Revenue* v. *P. G. Lake, Inc.*, 356 U.S. 260, upon which the Court premised its decision, is clearly distinguishable and does not apply to the facts or law governing this proceeding.

1. In the five cases involved in *Commissioner* v. *P. G. Lake, Inc.*, supra, each of the taxpayers created or carved out a portion of their greater mineral interest in producing

properties, specifically for a direct sale or exchange for money or other property. They then disposed of such smaller interests, reserving in themselves the residuum.

In each instance, there was current production in amounts reasonably estimated to pay out such carved out payments within a short period of time, and such payouts did, in fact, occur.

This Court, we agree, in a lucid opinion by Mr. Justice Douglas (who, we note, would deny the writ of certiorari in this case), correctly treated such proceeds as assignments of future income under the reasoning of *Helvering* v. *Shaffner*, 312 U.S. 579, *Helvering* v. *Clifford*, 309 U.S. 331, and *Helvering* v. *Horst*, 311 U.S. 112, under the particular facts there involved.

We respectfully and earnestly submit, however, that the case of *Commissioner* v. *P. G. Lake, Inc.*, supra, is wholly inapplicable to the case at bar, both in facts and in law, for the following reasons:

A. In *Commissioner* v. *P. G. Lake, Inc.*, supra, each taxpayer carved out of a presently owned producing mineral interest a specific production payment interest for a sale or exchange to a specific assignee, reserving to themselves the remaining mineral interest.

B. In the instant case, there are three distinct and separate transactions involved. In the first transaction, respondents reserved from an oil and gas lease to Cabot Carbon Company (1) the usual landowner's royalty interest of one-eighth, and (2) out of the lessee's normal seven-eighths interest, "90% of all oil, gas and other hydrocarbons in and under and that may be produced and saved from" the lands then leased until they had received $300,000.00, plus interest at the rate of 5 1/2% per annum. (R. 27). Neither of said interests so reserved were dependent upon,

carved out of, or affected by the other. *Wiseman* v. *Barby*, 380 F.2d 121.

Respondents, in said leasing transaction, therefore, were initially the recipients, and not the purveyors, of a production payment out of the lessee's normal seven-eighths interest. Upon payout of said production payment, if, as and when it occurred, the reversion would not come to respondents, as it did to the taxpayers involved in each of the cases in *Commissioner* v. *P. G. Lake, Inc.*, supra, but to the lessee, Cabot Carbon Company. Respondents' interest therein, instead of being restored upon payout of the production payment, as in the *Lake* cases, would have been completely extinguished.

After said leasing transaction was completed, and respondents became the holders of said production payment, they entered into a second transaction, i.e., an outright sale of an undivided one-half interest in said production payment in an arms length transaction, to a disinterested third party, Eby, Inc. (R. 109, Par. 19).

Then, still later, respondents entered into a third transaction, i.e., an outright sale of the remaining undivided one-half interest in said production payment, in an arms length transaction, to yet another disinterested party, Tokay Oil Company. (R. 109, Par. 19).

C. Respondents, therefore, at the time of sale, were the owners and holders of a production payment interest "* * * a property distinct and separate from the royalty interest, and a property in which taxpayers retained no reversionary interest * * *", as stated by Judge Pickett in *Wiseman* v. *Barby*, supra, which constituted an "economic interest in the oil, in place", *Palmer* v. *Bender*, 287 U.S. 551, 557, constituting a share "in the oil in the ground" which "was a reservoir of capital investment of the several

parties" (Ibid, 557); a capital asset held for more than six months, as defined by Sections 614 and 1221, Internal Revenue Code of 1954, 26 U.S.C, 1964 Ed., Sec. 614, 1221. (Respondents' Brief in Opposition, pp. 6-21 incl.).

Respondents' conveyances, then, of their entire interest in said production payments bring this case clearly within the holding of this Court in *Blair* v. *Comm.*, 300 U.S. 5, rather than that of *Helvering* v. *Shaffner*, supra, *Helvering* v. *Clifford*, supra, or *Helvering* v. *Horst*, supra.

Here, as the taxpayer had in *Blair* v. *Comm.*, supra, where he had conveyed fractional interests of his entire life estate in a trust, respondents similarly conveyed fractional interests in their total interest in the production payment involved. Just as this Court in *Blair* v. *Comm.*, supra, distinguished its decisions from *Lucas* v. *Earl*, 281 U.S. 111, and *Burnet* v. *Leininger*, 285 U.S. 136 (where the respective taxpayers had attempted to assign future salaries and fees or future partnership income), by holding that the income from the equitable interest assigned by Blair of his lifetime interest constituted an equitable interest in the corpus of the property, thus followed the owner of the property; so here, respondents conveyed their total interest in said production payment property from which future income was to be derived by their assignees, who became not only the owners immediately of such production payment, but also of all the income thereafter received therefrom.

Mr. Justice Douglas, in *Commissioner* v. *P. G. Lake, Inc.*, supra, pointed out that "only a fraction of the oil or sulphur rights were transferred, the balance being retained," and called attention at that point (by footnote No. 5) to I. T. 4003, 1950 Cum. Bul. 10, 11, which contained the following specific exception to the rule announced in

said ruling, holding that receipts from all oil payments constituted ordinary income:

> "Notwithstanding the foregoing, G.C.M. 24,849, supra, and I.T. 3895, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property, or a fraction extending over the entire life of the property."

In *Commissioner* v. *P. G. Lake, Inc.*, supra, the taxpayers simply temporarily assigned a portion of their future income from the mineral property, out of which they carved the oil assignments. Here, respondents conveyed their entire interest in said production payment, thus clearly falling within the exception to ordinary income treatment pointed out by Mr. Justice Douglas under said footnote No. 5 to said opinion. The proceeds received from said sales were not, therefore, assignments of future income, but consideration received for the entire asset conveyed, and thus taxable as capital gains.

We submit, that for the aforesaid reasons, the case of *Commissioner* v. *P. G. Lake, Inc.*, supra, is not controlling of the facts or law of the instant case, and that this Court should grant a rehearing in this proceeding in order that petitioners may clearly so demonstrate.

2. The Congress, though cognizant of attempts of the Treasury Department to treat the assignment of oil payments as ordinary income, has refused to change the law applicable thereto. During the period prior to the Second Session of the 84th Congress of the United States, the Treasury Department had, in the following cases, attempted to assess a tax upon the premise that the assignment of carved out oil payments constituted the assignment of future income taxable as ordinary income, and not under the capital gain provisions:

Hawn v. *Comm. of Internal Revenue*, 23 T.C. 516, Decided 12-23-54, later reversed (C.A. 5) 231 F.2d 340.

Caldwell v. *Campbell*, (C.A. 5) 218 F.2d 567, Decided 1/12/55.

P. G. Lake, Inc. v. *Comm. of Internal Revenue*, 24 T.C. 1016; Decided 9-20-55.

W. F. Weed, Individual, and Estate of Eleanor M. Weed, deceased, W. F. Weed, Executor, v. *Comm. of Internal Revenue*, 24 T.C. 1025, Decided 9-22-55.

Wm. Fleming and Bessie M. Fleming, husband and wife, v. *Comm. of Internal Revenue*, 24 T.C. 818, Decided 7-25-55.

John Wrather and Nell Wrather, husband and wife, v. *Comm. of Internal Revenue*, T.C. Memo Dec. —Dkt. No. 38267, Decided 4-26-55.

Dennis M. O'Connor, et al. v. *Frank Scofield, former Collector of Internal Revenue*, (W. D. Tex.) 143 F. Supp. 240, Decided 3-28-56.

In each of said cases, the lower courts had held to the contrary and treated such sales as subject to the capital gain provisions.

H. R. 9559 was introduced in said 84th Congress, Second Session. In said bill, several new sections, most of which were recommended by the Tax Section of the American Bar Association, as attested by the testimony of the Section Chairman contained in pages 197-260, inclusive, and particularly at pages 243-246 and pages 256-260 of Hearings before a Subcommittee of the Committee on Ways and Means, House of Representatives on Technical Amendments to the Internal Revenue Code, Eighty-Fourth Congress, Second Session, would have been added to the Internal Revenue Code of 1954. A proposed new section 633 governing the sale or gift of oil or production payments carved

out of a larger property would have treated the income therefrom as ordinary income, subject to a depletion allowance. Section 1221 (defining a capital asset) would have been amended by adding thereto an exception from the definition of a capital asset of "an oil, gas or production payment described in Section 633." Section 1231 (relating to the definition of property used in a trade or business) would have been amended by excluding an oil, gas or production payment described in Section 633.

Merten's Law of Federal Income Taxation, at p. 261, in note 40, reports as follows:

> "In connection with the Technical Amendments Bill of 1957, the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee published a list of unintended benefits and hardships which it intended to study. First on this list were oil and other mineral production payments, as to which the following comment was made:
>
> "A practice has developed under which the owners of oil or mineral properties sometimes carve out and sell a portion of their future right to oil or other mineral production, such as the right to receive the first $50,000 realized from the production of oil, or the right to receive the first 10,000 barrels of oil. Recent court decisions have held that the sale of a production payment carved out of any interest which the taxpayer has in an oil well is eligible for capital gain treatment. Also, it has been held that a taxpayer who gave a mineral payment to a charity was entitled to a charitable deduction for the value of the payment and at the same time could exclude the mineral income from his taxable income.
>
> "It is suggested that the proceeds received from the sale of oil and other mineral production payments by persons who carve them out of larger interests be treated as ordinary income from the production of

minerals. In the case of donations of carved-out production payments, adjustments would be made to prevent double benefits; that is, the benefit both of an exclusion from income and a charitable deduction.

"It is suggested that the subcommittee may also want to examine various other arrangements by which interests in oil and other mineral production are sold, such as cases where the production payments are sold after the taxpayer has previously disposed of operating interests in mineral production."

None of said proposed amendments, neither by the 84th or the 85th Sessions, were ever adopted by the Congress. The only legislative change with reference to the treatment of oil payments of which counsel is aware, is that contained in Section 543 (a) (3), Section 543 (b) (2) B, and Section 543 (b) (4), all related to personal holding company income. (26 U.S.C., 1964 Ed., Sec. 543).

The reason for such change was clearly stated in Senate Report No. 830, Part 2, 88th Congress, Second Session, where at page 250, appears the following:

"* * * an amendment has been added to section 543 (b) (4) to specifically include production payments and overriding royalties as mineral, oil and gas royalties for purposes of classification as personal holding company income under section 543 (a).

"The Treasury regulations interpreting section 543 (a) (8) of existing law currently define the term 'mineral, oil, or gas royalties' as including production payments and overriding royalties. (See Reg. Sec. 1, 543-1 (b) (11) (ii).) However, it has been brought to the attention of your committee that this interpretation of existing section 543 (a) (8) is disputed by some taxpayers. Your committee's amendment would make it clear that production payments and overriding royalties are to be treated as mineral, oil, and gas royalties under proposed section 543 (b) (4).

This amendment is not intended to affect any case involving interpretations of section 543 (a) (8) of existing law."

Said amendment was apparently in response to the case of *U. S.* v. *525 Company*, (5 Cir.) 342 F.2d 759, decided March 22, 1965, which held void a Treasury Regulation under Section 543 (a) (8), of the prior act that attempted to include income from the sale of oil payments as mineral oil and gas royalties.

Whereas, Congress has seen fit to make the above described amendment, limited only to personal holding company income, it has never adopted the proposed changes recommended by the House Ways and Means Committee of defining oil payments and overriding royalties as an exclusion to the definition of capital assets contained in Section 1221 of the Internal Revenue Code, or in an exclusion to the definition of property used in a trade or business in Section 1231, Internal Revenue Code, nor has it added any provision which would tax the proceeds from oil, gas or production payments as ordinary income as was proposed by the House Ways and Means Committee in such two consecutive sessions of Congress.

In view of such pointed refusal of the Congress to adopt the policy of the Treasury Department to tax the proceeds from the sale of production payments as ordinary income, we respectfully suggest that this Court does not propose to do that which Congress itself has refused to do.

As a matter of fact, this Court in *Cary* v. *Donohue*, 240 U.S. 430, in respect to preferential transfers in bankruptcy cases, states:

"We cannot but regard the action of Congress as a deliberate refusal to conform the requirement of Sec-

tion 60 to those of Section 3 b, and we are not at liberty to supply by construction what Congress has clearly shown its intention to omit."

In *Western Union Telegraph Co.* v. *Lenroot*, 323 U.S. 490, on the construction of child labor laws, this Court stated:

> "It is admitted that it is beyond the judicial power of innovation to supply a direct prohibition by construction. We think we should not try to reach the same result by a series of interpretations so far-fetched and forced as to bring into question the candor of Congress, as well as the integrity of the interpretative process. * * * To translate this act by a process of interpretation into an equivalent of the bills Congress rejected is, we think, beyond the fair range of interpretation."

In *Helvering* v. *Wood*, 309 U.S. 344, involving whether income from an irrevocable short term trust should be taxed to the grantor-trustee, under Sec. 166 of the Revenue Act of 1934, 48 Stat. 680, 686, 729, 26 U.S.C.A., Par. 166, Mr. Justice Douglas stated, with respect to the province of the Court, as follows:

> "And so far as Sec. 166 is concerned, no apparent or lurking ambiguity require or permits us to divine a broader purpose than that expressed. The legislative history corroborates this conclusion. When the 1934 Act was before the House Committee, the Treasury recommended that income from short term trusts and from revocable trusts be taxable to the creator. The Congress adopted the latter by an appropriate amendment to Sec. 166; but it did not select the former for special treatment. When such clear choice of ideas has been made in the drafting of a specific provision of the law, its language must be taken at face value. Sec. 166 is therefore not applicable to this trust since respondent is given no power to recall the corpus. * * *"

CONCLUSION

By reason of the foregoing, the petition for rehearing should be granted, in order that this case may receive the full consideration that justice requires.

Respectfully submitted,

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CERTIFICATE OF COUNSEL

I HEREBY CERTIFY that the foregoing petition for rehearing is presented in good faith and not for purposes of delay.

.....

JOHN K. SPECK

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967.

WISEMAN, ETC. *v.* BARBY ET UX.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT.

No. 871. Decided March 11, 1968.

PER CURIAM.

The petition for a writ of certiorari is granted and the judgment is reversed. *Commissioner of Internal Revenue* v. *P. G. Lake, Inc.*, 356 U. S. 260.

MR. JUSTICE STEWART and MR. JUSTICE WHITE are of the opinion that the petition for a writ of certiorari should be granted and the case set down for oral argument.

MR. JUSTICE DOUGLAS is of the opinion that the petition for a writ of certiorari should be denied.